14th workshop on alternative economic policy in Europe

September 26th – 28th, 2008, Brussels

The economic and social state of the Union

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Introduction

- From a structural point of view, September 2008 can be appropriate to make an assessment of the first 10 years of the single currency (launched in January 1999). We also need to address the progress in the Lisbon Agenda, in structural reforms, in tax and social harmonisation.
- But, in the short term, the main issues are the financial crisis and the economic recession.
- The recession shows the inability of the current governance in Europe to support growth and to react to shocks.

  A recurrent question is: How to improve European governance?

Introduction

- More fundamentally, the crisis shows the limits of the capitalist growth model.
- The limited amount of oil and raw material resources like the rise of environmental constraints requires a global management of natural resources.
- The financial crisis shows the limits of a system based on the domination of financial markets and speculation. The massive public intervention in the US and the UK shows that a deregulated financial system is not viable.
- The crisis can be an opportunity to challenge the dominance of liberal ideology and to highlight the need for greater social intervention in economic fields.
- The key task in the current period is to show that the system cannot be corrected by minor reforms (such as a more sophisticated regulation of financial markets). We need a major change in economic functioning; this change must be credible; this change requires a new sociological and political alliance.

The 2007-2008 crisis

The crisis has four components:

- The rise in energy and other raw material prices.
- The fall in the dollar.
- The housing crisis.
- The financial crisis.

The rise in energy and raw material prices

- Prices started to rise in 2005. From 2004 to 2008.2, oil prices rose by 217% for the Brent in \$, 152% for the Brent in €, 122% for raw materials in \$, 77% for raw materials in €.
- This increase is mainly explained by structural factors. Strong demand was driven by growth in emerging countries while supply remained stable. The tension is particularly strong for oil, where production is expected to remain stable before falling.
- Recently, these factors were exacerbated by the financial crisis. Substantial capital flows were invested in the oil or raw material derivative markets, contributing to increased prices.
- Since two months, prices have been decreasing, under weak global growth prospects and for some products, an increase in supply. However, prices are likely to remain high and to rise again in the medium term.
- But, in the short term, the inflation rate should dramatically fall in 2009.

Brent and imported raw material prices

	Brent in $	Brent in €	Raw materials in €
2000	28.5	30.9	100
2001	24.4	27.3	85.6
2002	25.0	26.5	90.4
2003	28.9	25.6	86.8
2004	38.3	30.8	86.6
2005	54.5	43.9	116.4
2006	64.1	51.0	136.3
2007	72.5	52.9	144.5
2008.1	96.8	64.9	150.1
2008.2	121.5	77.8	154.1
2008 September 20	93.1	64.2	151.8 (August)

This rise in prices has 4 consequences:

- It generates a shock on the price level, which looks like an inflation revival. This shock increases the diversity among EU countries. It makes euro membership more difficult for several NMS. As the ECB refuses to distinguish price levels and inflationary shocks, ECB maintains a relatively high target interest rate.
- The shock is a tax on the purchasing power of MS. Who will pay: workers or companies?

  Wage growths remain weak in all old MS in 2008. There is no evidence that workers will obtain a full wage indexation on prices. In most countries, real wages will decrease in 2008, even if productivity grows. In the Euro zone, real wages decreased by 0.5% in 2008-Q1 after a 0.5% increase in 2007-Q1. In most countries, social benefits were not fully indexed on prices. The fall in households' purchasing power will induce a fall in consumption.

IPCH inflation rate (y-o-y)

	August 08	August 07	August 08*
UE27	**4.2**	**1.9**	**2.9**
EA	**3.8**	**1.7**	**2.6**
The Neth.	3.0	1.1	2.0
Portugal	3.1	1.9	2.6
Ireland	3.2	2.3	2.1
Germany	3.3	2.0	1.9
France	3.5	1.3	2.3
Austria	3.6	1.7	2.4
Sweden	**4.1**	**1.2**	**2.3**
Italy	4.2	1.7	3.2
UK	**4.4**	**1.8**	**2.6**

***without energy and raw products.**

IPCH Inflation rate (y-o-y)

	August 08	August 07	August 08*
Slovakia	**4.4**	**1.2**	**4.2**
Poland	**4.4**	**2.1**	**3.8**
Finland	4.6	1.3	3.3
Greece	4.8	2.7	3.8
Denmark	**4.8**	**0.9**	**3.7**
Spain	4.9	2.2	3.5
Belgium	5.4	1.2	2.9
Slovenia	**6.0**	**3.4**	**4.8**
CZ	**6.2**	**2.6**	**5.7**
Hungary	**6.4**	**7.1**	**5.4**
Romania	**8.1**	**5.0**	**7.5**
Estonia	**11.1**	**6.1**	**9.3**
Lithuania	**12.2**	**5.6**	**10.0**
Latvia	**15.6**	**10.2**	**13.7**

***without energy and raw products.**

This rise has 4 consequences:

- Consuming countries must accept the rise of energy prices; they could implement measures to offset the effect on the poorest.
- The rise in oil prices generates an increase in the world saving rate. In consuming countries, it reduces income, therefore consumption. At the global level, it induces a demand gap, which should be filled by lower interest rates. Richer countries should accept a rise in their external deficit and in their public or private (households or firms) debt. If the shock weighs on households, an increase in the public debt or household debt is necessary. If the shock weighs on firms, then firms must accept to be more indebted or must issue shares that will be purchased by the new rich countries (sovereign funds). But, the financial crisis might prevent this increase in debt.

The fall of the dollar

- Since 2006, the fall of the dollar has contributed to depress European output, while its high level in 2000-2002 had contributed to the high growth level in the EU during these years.
- The euro has risen not only vis-à-vis the dollar but also against many Asian currencies pegged to the dollar.
- From 2004 to 2008, the Chinese Yuan increased by 17.5% against the dollar, but remained stable in euros.
- Asian countries follow a policy of low exchange rates to stimulate their growth. In the US, active monetary policies lead to sharp cuts in interest rates during recession periods. Due to the inertia of the ECB, the exchange rate of the euro is too strong given the required growth of most countries in the area; it tends to increase during periods of recession.

Euro-dollar exchange rate

1999	2000	2001	2002	2003	2004	2005	2006	2007-1	2007-2	2008-1	2008*
1.066	0.92	0.90	0.94	1.11	1.24	1.24	1.26	1.33	1.41	1,53	1.45

* September 20.

The Housing bubble

- During the last 12 years, many European countries (particularly Spain, the UK, and Ireland) had experimented a strong growth of the housing investment, due to favourable credit condition. This expansion was accompanied and facilitated by a burst on housing real prices. Real estate has strongly supported the growth in the Anglo-Saxon countries and in Spain.
- In 2007, the housing market turned. Prices began to fall. The financial crisis has raised awareness of the risks of credit. The reversal is particularly violent in Spain, Ireland and the United Kingdom as it is in the US.

Residential Investment (average annual growth rate)

	2005-1995	2006-2007	2008-2009[p]	Housing real prices in 2007 2000=100
Germany	–2.2	3.0	–0.4	83
Italy	0.9	3.6	–0.8	147
France	2.5	5.0	0.5	181
UK	4.0	5.9	–2.1	180
Spain	8.2	4.7	–9.9	194
Ireland	9.6	–4.7	–15.1	159
US	5.4	–10.8	–16.5	137

p OCDE June 2008 forecast.

The financial crisis

- From 1980 to 2007, the world economy was dominated by the growth of financial capitalism.
- Masses of capital increasingly large have been invested in financial markets. The strong profitability they required was obtained by increasing the share of profits in value added but mostly by stock market bubble.
- The race for profit has fed permanent financial innovations. Hedge funds have used the leverage, i.e. the difference between the rate of profit and interest rates, to obtain extravagant returns.
- The increase in the stock exchange values and the housing prices had strongly supported household consumption in the Anglo-Saxon countries.
- Financial deregulation and marketization have become the norm at the expense of continental model based on the banks expertise.

The financial crisis

- The subprime crisis of 2007 has destroyed this edifice.
- Much of mortgages made in the United States had benefited to fragile households: they could not support rising interest rates and falling housing prices.
- The losses induced by the subprimes weakened the whole financial sector by a domino effect. It appeared that the rating agencies were unable to properly assess the risk of these credits. The decline in the value of securitized loans weakened the banks balance sheets; put in bankruptcy the most fragile; induced a dramatic fall of the value of financial institutions stocks and destroyed confidence in the interbank market.
- The central banks had to intervene to ensure market liquidity and then to organize the rescue (or the failure) of the more fragile banks. Real estate and stock prices have dramatically fallen.

The financial crisis

- The impact of the crisis was affected by the *pricing to market*, the *pricing to model* and the IFRS norms, which requires to immediately record losses on financial assets (*fair value principle).* In high uncertainty situations, financial assets are depreciated in the markets, this requires putting a strong aversion to risk in the models and tends to depreciate more sharply all assets. Banks are forced to use these values in their sheets, even if they consider that assets are worth more than that (because the market is exaggerating losses).
- The IMF estimates the cost of the crisis to 945 billion dollars, 225 from losses on credit depreciation and 720 from assets depreciation. Half would be borne by banks and the rest by investment funds. These losses are distributed worldwide since European banks, investment funds or pension funds have invested heavily in the United States, by buying securitized credits, or by becoming shareholders of US financial institutions, as Crédit Agricole which has made heavy losses on Calyon and Natixis on CIFG. Does the diversification compensate the risk of asymmetric information that we incur when we invest far from our bases?

The effect on growth

- The wealth effect (financial and real estate) tends to reduce households consumption.
- The housing investment is falling.
- Firms reduce investment due to uncertainty, balance sheet effects, loss of competitiveness and credit restriction.
- Banks restrict credit due to balance sheets deterioration (their balances as the firm and the households' balances) and to risk aversion.
- Banks increase interest rate on credit to recover their balance sheets and to compensate the risk.
- It will take time for companies and banks to recover a satisfactory financial situation.
- Low interest rates may reduce this period, but it runs the risk of inducing a new bubble.

Discrepancies between US and the Euro zone

- The US financial sector is more affected. But, the Fed reacts to the crisis by lowering the rate from 5.25% to 2%, low interest rates helping to improve the balance sheet of banks. Instead, the ECB is trying to separate monetary policy for the policy to assist banks in difficulty. The crisis has not prevented the ECB to increase its rate of 4 to 4.25%.

	US		Euro zone	
	July 2007	**August 2008**	**July 2007**	**August 2008**
Interest rate (3 months)	5.25	2	4	4.25
Interest rate (10 years)	5.2	3.7	4.7	4.2
GDP (forecast)	2.45	1.5	2.5	1.3
Inflation rate (forecast)	2.55	3.4	2	3
Public balance	-2.2	-5.6	-0.5	-0.9

The Financial crisis

- The issue of the crisis can be discussed at two levels. In the short term, the governments must stop the fall of property prices and of stock market and must avoid financial institutions bankruptcy. To reduce moral hazard, they must avoid rewarding the vice: the managers must be dismissed and shareholders and investors must be ruined.
- As in the Paulson plan, the State must buy at low prices the depreciated assets of the banks and must recapitalize banks if necessary.
- For the long term, two strategies are possible. The first is to impulse the revival of financial markets, with just a little more regulation. The second is to go back to a financial system focused on its primary objectives, to finance productive activities, to offer depositors low but guaranteed returns; banks must forget speculative activities. The German view rather than the Anglo-Saxon view…

The Financial crisis

- All relationships of banks and firms with tax or regulation heavens must be forbidden.
- The financial sector must be deflated, for example by providing public retirement pensions, by promoting direct investment.
- Financial innovations whose security is not guaranteed or the risk is not calculable must be forbidden. Financing of speculation by banks must be forbidden. The remuneration of operators should be controlled. Hedge funds must be restricted by preventing them from using leverage effects.
- Central Banks must use instruments such as reserve requirements or capital ratios on credit, which should vary depending on market conditions and on type of credit. It must deter property loans during the housing bubble and stock market speculation in times of financial bubbles.
- The choice between the two strategies is a political issue. The financial crisis may be an opportunity for the anti-liberals to engage points on the ideological level, to show that the financial capitalism is dangerous and to build a coalition for change.

2008-2009: Two years of recession

- The old EU15 countries are expected to have virtually no growth in the second quarter 2008, the slowdown will be particularly marked in Spain, Ireland and the UK most affected by the housing crisis.
- Confidence, according to the surveys of the European Commission, is still on a declining trend from 115 in August 2007 to 88 in July 2008.
- Unemployment rate should stop to decrease (Germany); It should increase weakly (France, Italy, IK) or more dramatically (Spain).
- The growth should remain satisfactory in the NMS who has a specific dynamism. However, Estonia and Latvia suffer from a banking and housing crisis.

The 2007-2008 crisis

Growth prevision

	2007	2008	2009
US	2.0	1.8	1.4
UE27	2.9	1.6	1.1
EA	2.6	1.3	0.9
Austria	3.1	2.2	1.7
Belgium	2.8	1.6	1.5
Finland	4.5	2.5	2.2
France	2.1	1.1	1.0
Germany	2.5	1.9	0.8
Greece	4.0	2.9	2.8
Ireland	6.0	–0.2	–1.1
Italy	1.4	0.2	0.5
Netherlands	3.5	2.2	1.3
Portugal	1.8	1.1	1.0
Spain	3.8	1.4	0.5

Source : Consensus forecast, September 2008.

The 2007-2008 crisis

Growth prevision

	2007	2008	2009
Denmark	1.7	0.9	0.8
Sweden	2.7	1.7	1.6
UK	3.1	1.2	0.6
Czech Republic	6.6	4.5	4.4
Estonia	7.1	0.5	2.7
Hungary	1.3	2.2	3.1
Latvia	10.3	0.9	1.2
Lithuania	8.8	5.2	3.9
Poland	6.6	5.4	4.7
Slovakia	10.4	7.5	6.3
Slovenia	6.1	4.5	4.3
Bulgaria	6.2	5.8	5.4
Romania	6.0	6.8	5.2

Source : Consensus forecast, September 2008.

The 2007-2008 crisis

- The downturn in the Euro zone was first induced by the households' consumption and investment; since 2008-Q2, the exportation slowed; then, the productive investment.

Euro Zone : Growth in 2006-2009

	2006	2007	2008	2009
Households consumption	2.0	1.6	0.4	1.0
Housing investment	6.1	2.4	–0.9	–3.2
Productive investment	6.1	6.1	2.9	1.0
Exportation	8.1	6.1	3.4	3.7
Importation	8.0	5.5	2.9	3.6
GDP	3.0	2.6	1.2	1.1
Consumption price	2.2	2.1	3.4	2.1
Unemployment rate	8.8	7.5	7.4	7.8

What economic policy answers?

The monetary policy

- The ECB increases its interest rates from 4 % to 4.25% on 9th July 2008, when the Fed goes down from 6.75 in July 2007 to 2.75 now. The ECB considered that the risk of inflation was more important than the risk of recession. Its main objective was to dissuade employees to claim wage indexation and to guaranty that the petroleum and raw material prices rise be paid by the workers and not by the firms.
- The financial crisis increases the interbank interest rate. There is a risk of credit crunch. Inflation rate should decrease in 2009.
- The rise in prices in the euro zone reached 4% in July 2008 so that we can not accuse the ECB of rigor, to make too much effort not to exceed the 2% target. But the rise of energy price requests other actions than rising interest rates. We need an interest rate cut to offset the rise of the world savings rate; we must accept the direct effect on the consumption prices indexes; we must accept an increase in the public deficits and a decrease in profit businesses; we need a fiscal policy to concentrate purchasing power losses on the richest and to save the poorest. The organization of economic policy in the area zone does not allow such a policy.

What economic policy answers?

Fiscal policy

- In 2007, the fiscal situation of most Euro MS seems very favourable. France was the only country to have a fiscal structural primary deficit.
- Despite the recession, the European authorities have not changed strategies; “countries in surplus or in equilibrium should not do more than let the automatic stabilizers; the others should pursue to reduce their structural deficit”.
- In France, the Sarkozy government decided in late 2007 a tax package that represents 12 billion € (0.6 percentage point of GDP) for 2008. France is therefore right to the limit of 3%. Germany has decided on tax cuts that mainly benefit the companies (0.4 percentage point of GDP). Spain is the only country to announce an expansionary package (1 percentage point of GDP): support for housing, abolition of the wealth tax, tax cut of 400 € by household.

What economic policy answers?

- In total, in 2008, the fiscal stimulus should only be 0.3% of GDP in the euro area; much less than in the United States and Great Britain.
- As in 2002, the economic governance of the Euro zone does not allow a strong and coordinated reaction against the recession.

What economic policy answers?

	Public balance		Structural primary balance
	2008	**2007**	**2007**
Finland	4.4	5.3	4.2
Spain	0.8	2.2	3.2
Netherlands	1.1	0.4	2.1
Germany	–0.5	0.0	2.2
Belgium	– 0.4	–0.2	3.4
Austria	–0.7	–0.7	1.4
Italy	–2.5	–1.9	3.0
France	–3.0	–2.7	–0.4
Portugal	–2.6	–2.7	1.2
Greece	–2.1	–3.1	0.7
Euro Zone	–1.1	–0.6	1.9

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What economic policy answers?

	Public balance		Structural primary balance
	2008	**2007**	**2007**
Denmark	3.8	4.5	3.7
Sweden	3.1	3.4	2.4
UK	–4.8	–3.0	-1.1
CZ	–1.5	–1.6	–2.1
Poland	–2.6	–2.0	–1.0
Slovakia	–2.0	–2.2	
Hungary	–4.1	–5.5	–2.3
US	–5.5	–3.0	–1.1
Japan	–1.4	-–2.4	-–1.8

What economic policy answers?

A common strategy ?

- Almunia (September 2008) refuses any change in the monetary and fiscal policies framework. He claims structural reforms: "Measures to enhance the flexibility of product, labour and services markets would increase potential growth and would boost consumer and investor confidence. We need a full implementation of the Service directives; we need to remove barriers to entry in energy market; we need to implement reforms of the labour markets".
- In September, at the Nice summit, the EU economy and Finance ministers and the Central Bank governors "decided to mobilise common and national policies to respond to situations that may vary from one country to another".

But, the decisions were very poor:

- "In budgetary matters, the Member States could let the automatic stabilisers work to support activity, while continuing their efforts to control spending and respect the 3% deficit limit;
- The structural reforms should be continued as they contribute to restoring purchasing power by increasing competition;
- The European Investment Bank (EIB) will support SME funding, thanks to the increase in its financial means (by 15 billion euros in 2008-2009 or more than 50% over two years, and 30 billion by 2011)".

What economic policy answers?

A common strategy ?

- In fact, no common fiscal strategy was decided. The structural reforms concern mainly the market labour liberalization or good markets deregulation. The ministers did not learn from the financial crisis that it is the capital market which is the main problem, that liberalisation and reregulation are the problem, not the solution.
- The actual economic policy framework does not allow a strong reaction in the short term, neither in monetary policy, neither in fiscal policy.
- Europe also needs a reflexion on its structural strategy. But the Commission refuses to engage it.

10 years of EMU

- Before the launch of the euro, the proponents of EMU thought that the single currency would induce rapid economic convergence within Member States.
- But there have been persistent and sometimes rising divergences in the monetary union in terms of output growth, inflation, unemployment and external balances since 1999.
- The introduction of the single currency made winners (Ireland, Spain, Greece) and losers (Germany, Italy, the Netherlands, Portugal).
- The functioning of the euro area, by requesting similar macroeconomic policies for countries in different situations, has increased growth disparities in the Member States.
- European institutions and rules set by the Treaties (ECB, Stability and Growth Pact) were unable to tackle these divergences.

10 years of EMU

- The Euro was a success from a monetary point of view, but not from an economic one.
- In most economies, especially the bigger ones, the introduction of the euro did not result in the promised acceleration of growth, but in the persistence of a poor trend.
- At the end of 2007, eight euro area countries remained in a mass unemployment situation.
- The growth of labour productivity remains low in most Euro MS, especially in Spain, Italy, France and Belgium. The Euro did not deliver the promised increase of productivity due to liberalisation and accrued concurrence.

10 years of EMU

- Euro area countries have been unable to define a common growth strategy, hesitating between:
  - A social-Keynesian strategy, with a strong commitment to maintaining an active economic policy, the European Social Model (ESM) and an industrial policy;
  - A liberal strategy based on market deregulation and reform of the ESM through public expenditures cuts and a smaller role of the State in the economy.
- This debate takes place in the context of globalisation, which makes it necessary for Continental European countries to adapt.
  - Should they move towards a liberal or a Scandinavian model?
  - Should this choice be made at a European or national level?

10 years of EMU

- Euro area GDP growth was rather satisfactory between 1985 and 1991 (3.1% per year).

  Annual GDP growth decelerated by 1.3 percentage points between 1992 and 1998 due to a bad management of the German reunification and to restrictive fiscal policies implemented in the convergence process to meet the Maastricht criteria.

  The launch of the euro in 1999 did not enable the area to grow at a more satisfactory rate.

- Since 1997, GDP growth has been clearly weaker in the euro area (2.25% per year) than in the UK (2.9%) or the US (3.0%).

  Non euro area EU members have performed better than euro area members.

- If we look on per capita GDP level, it appears that, in 10 years, all NMS have succeeded an important catch-up. The Scandinavian countries and the liberal ones (Ireland and the UK) had relatively strong growth. It was also the case for Spain and Greece. The performances of the 3 bigger economies and of Portugal were poor.

GDP (average annual growth)

	1997-2000	2001-2003	2004-2007
US	4.2	1.6	2.95
Japan	1.6	0.6	2.25
EU27	3.15	1.5	2.55
EA12	3.05	1.2	2.25
Germany	*2.3*	*0.35*	*1.8*
France	*3.2*	*1.35*	*2.0*
Italy	*2.2*	*0.75*	*0.95*
Spain	*4.5*	*3.1*	*3.65*
Netherlands	*4.2*	*0.75*	*2.7*
UK	3.35	2.4	2.75
Sweden	3.82	1.4	3.5
Poland	5.2	2.15	5.4
Hungary	4.7	4.2	4.55
CZ	0.85	2.65	5.5

Unemployment disparities

- From 1998 to 2007: slight decrease in unemployment rates in most euro area countries (except in Portugal).
- Rapid decrease in unemployment rates in four countries:
  - Ireland and Finland, thanks to robust GDP growth;
  - Italy thanks to low labour productivity growth;
  - Spain thanks both to growth and low labour productivity.

  However in 2007, eight euro area countries remained in a mass unemployment situation.
- In terms of employment rates:
  - Italy stands clearly below partner countries; then comes Belgium;
  - Other MS can be split into two groups:
  - ‘Medium rate’ countries: Germany, Greece, Spain, France, the Netherlands;
  - ‘High rate’ countries: Ireland, Austria, Portugal, Finland, and outside the area: Sweden, Denmark and the UK;
  - Scandinavian and liberal countries perform well (and also Austria). Medium rate countries need to raise their employment rate almost by 10% to reach the UK level (18% for Italy). European countries need more jobs and not more workers.

Unemployment and employment rates

	Unemployment rate, %		Employment rate, % (full time equivalent)	Labour productivity growth rate, %
	1998	**2007**	**2005**	**1999-2005**
Euro area	10.1	7.4	59.8	1.0
Belgium	9.3	7.5	57.1	1.2
Germany	8.8	8.4	60.4	1.6
Greece	10.9	8.3	59.2	3.5
Spain	15.0	8.3	60.9	0.3
France	11.1	8.3	59.7	1.1
Ireland	7.5	4.5	64.6	2.8
Italy	11.3	6.1	55.5	0.4
Netherlands	3.8	3.2	60.9	1.3
Austria	4.5	4.4	63.7	1.5
Portugal	5.1	8.0	65.6	0.8
Finland	11.4	6.9	65.3	1.5
Denmark	4.9	3.7	69.4	1.6
Sweden	8.2	6.1	68.0	1.9
UK	6.1	5.2	65.4	1.7
US	4.5	4.6	67.0	2.2

Source: OECD.

Unemployment disparities

- Of the 27 EU countries, 9 have an unemployment rate above 7%, 9 have an unemployment rate of between 7 and 5% and 9 rate below 5%.
- Crucial policy issue: should demand be raised first, to induce higher labour demand hoping that labour supply will follow?

  Structural reforms (abolition of early retirement, better control of unemployment allowances) would be introduced only *ex post* and in countries where labour demand is clearly above labour supply – This strategy would involve inflationary risks.

  Or should countries where unemployment is high, start with structural reforms which would raise labour supply and employment? Such a strategy would raise a risk of raising unemployment and increasing poverty among the unemployed.
- A majority of countries with high unemployment rates chose to give incentives to companies to reduce labour productivity growth and to hire unskilled workers (Spain, Italy, Belgium France); other countries (Germany) tried instead to increase employment through competitiveness gains, especially through competitiveness gains, especially through higher productivity in the industry.
- The European Employment Strategy and the Lisbon Agenda did not succeed in imposing a common strategy.

Inflation differentials

- A good functioning of the monetary union requires avoiding the emergence of disparities in price levels.

  Different price levels will generate competitiveness differentials and will need to be corrected later through output growth differentials.

- Inflation differentials have remained substantial in the euro area.
- Countries with higher inflation rates were countries with:
  - Higher GDP growth (Spain, Ireland, Greece)
  - Or low initial price levels, due to the Balassa-Samuelson effect (Spain, Greece, and Portugal).
- However Italy and the Netherlands also had relatively high inflation rates. The Dutch economy ran at more than full capacity for several years and inflationary shocks were generated by increases in indirect taxation.
- Higher than the average inflation rates were in none of these countries due to excessive demand induced by excessive public deficits.

Real interest rates differentials

- Another issue in a monetary union: catching-up countries, like Spain, have higher GDP growth and inflation rates than other countries. It is therefore difficult to run a single monetary policy even in the absence of asymmetric shocks.
- With a single nominal interest rate, euro area countries have had different real interest rates corrected from growth. The single monetary policy was restrictive for Germany and expansionary for Ireland, Greece and Spain where companies and households had a strong incentive to borrow and invest, which boosted domestic GDP growth and inflation.
- In the 1999-2005 period, the average euro area interest rate was 3.1%, while a Taylor rule – based on a 2% inflation target and output gaps as estimated by the OECD – would have suggested rates of 1.75% for Germany, 3.05% for France, 3.8% for Italy, 4.0% for the area, and 8.05% for Spain.
- However the 2% inflation target may be judged too low. The euro area needs higher GDP growth and this may result in transitory inflationary pressures on some markets. The OECD potential output estimates are very low: the euro area output gap was estimated to be nil in 1999, when the unemployment rate was 9.2% and nil also in 2002, when the unemployment rate was 8.3%.

Inflation and real interest rates

	Price level	GDP Inflation	Real interest rate less GDP growth rate	
	2005	**1999-2005**	**1992-1998**	**1999-2005**
Euro area	100.0	1.8	2.5	-0.6
Belgium	101.1	1.7	1.6	-0.6
Germany	104.9	0.7	1.6	1.1
Greece	81.4	3.6	6.7	-3.3
Spain	88.6	3.9	2.1	-4.4
France	103.8	1.4	2.9	-0.5
Ireland	116.3	3.9	-3.5	-7.3
Italy	97.3	2.5	3.9	-0.6
Netherlands	103.5	2.7	0.9	-1.4
Austria	101.9	1.5	1.3	-0.4
Portugal	81.5	3.4	1.6	-1.7
Finland	109.5	1.2	1.3	-0.9
Denmark	*129.7*	*2.3*	*2.5*	*-0.9*
Sweden	*112.1*	*1.4*	*1.7*	*-0.8*
UK	*105.5*	*2.5*	*3.7*	*0.3*
US	93.9	2.2	-0.1	-2.4

Real interest rates differentials

- The ECB has been less concerned with GDP growth than the Fed, in good and in bad times. Consequently fiscal policies should have been more reactive in the euro area.
- Financial developments and globalisation make more and more difficult the conduct of Monetary policy. Low interest rate induces financial or real estate bubbles. High interest rate induces crisis.
- Since 1999, the monetary stance was:
  - Clearly more accommodative than suggested by a Taylor rule in the US;
  - More accommodative in the euro area too, but to a lesser extent;
  - More restrictive in the UK.

Interest rates: Taylor rule and actual Central banks’ objective rate

	1999	2000	2001	2002	2003	2004	2005	2006	2007
Euro Area									
Taylor rule EA	2.55	4.95	5.3	4.45	3.5	3.5	3.3	3.7	3.95
Actual rate	2.7	4.05	4.3	3.2	2.25	2.0	2.0	2.8	3.85
United States									
Taylor rule	4.9	6.95	5.1	2.75	3.7	4.85	6.15	6.15	5.15
Actual rate	5.0	6.25	3.9	1.7	1.15	1.35	3.2	5.0	5.0

Wage competition

- In the 1999-2006 period, wage share in GDP decreased at the euro zone level and in eight member states.
- From 2000 to 2006, real wages per worker did not increased in Italy, increased by only 0.5% per year in Austria, 0.6% in Germany and in Belgium, while it increased by 1.3% in France and in the Netherlands and 2.8% in the UK.
- Increasing company profitability and price competitiveness through downwards pressure on wages became a major strategy in several countries, like in Germany and Austria
- This strategy boosted exports but put a drag on private consumption in these countries, thus dampening demand in the whole euro area.

Adjusted wage share in GDP, 1998/2007

	Change in percentage point, 1998-2007
Euro area	**-2.0**
Belgium	-2.4
Germany	-3.0
Greece	-1.5
Spain	-5.5
France	- 0.2
Ireland	0.4
Italy	-0.2
Netherlands	1.5
Austria	-6.9
Portugal	1.2
Finland	- 0.9
Denmark	*-0.3*
Sweden	*-0.6*
UK	*0.6*
US	**-1.2**

Source: European Commission.

Wage competition: A non-cooperative game

- Winners: Germany and Austria which succeeded to support domestic GDP growth by a positive contribution of net exports (by around 0.5 percentage point of GDP each year).
- Losers: Spain and France (both 0.7 percentage point per year).

- Considering patterns of domestic and foreign demand, euro area countries can be divided into 4 groups:
  - ‘Winners’: Ireland, Spain, Greece - with both strong domestic and foreign demand;
  - ‘Bad guys’: Germany, Austria, Netherlands - offsetting weak domestic demand by strong gains in export demand;
  - ‘Losers’: Italy, Portugal - suffering from both low domestic and external demand;
  - ‘Victims’: France, Belgium, Finland - where a weak external demand partly offsets a satisfactory domestic demand.

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GDP and Domestic Demand growth rates, 1999-2005

%, per year	GDP	Domestic demand	Productive investment	Housing investment	Consum-ption
Euro area	**1.9**	**2.0**	**2.6**	**1.5**	**1.9**
Belgium	2.0	2.2	2.6	2.4	1.6
Germany	1.3	0.8	1.0	-2.7	1.0
Greece	4.3	4.2	9,1	2.6	3.4
Spain	3.6	4.3	6.6	7.1	4.0
France	2.2	2.9	3.3	3.2	2.5
Ireland	6.5	6.4	0.5	14.2	6.0
Italy	1.2	1.6	2.0	2.3	1.6
Netherlands	1.7	1.3	0.9	1.2	1.4
Austria	2.0	1.4	3.7	-3.2	1.6
Portugal	1.6	1.6	n.a.	n.a.	2.3
Finland	2.8	3.3	2.9	3.3	3.0
Denmark	*1.9*	*1.8*	*2.1*	*5.8*	*1.5*
Sweden	*2.9*	*2.0*	*2.8*	*10.9*	*2.4*
UK	*2.7*	*3.1*	*1.8*	*2.1*	*3.3*
US	**3.0**	**3.6**	**3.3**	**5.4**	**3.6**

Source: European Commission.

Competitiveness and current account balances

- The euro area as a whole won competitiveness from 1996 to 2001 thanks to the fall in the euro vis-à-vis the US dollar. A weak euro together with the NTIC bubble accompanied strong GDP growth (3% per year from 1997 to 2000) and employment growth (8.7% in five years)
  - This shows that the area keeps a substantial potential growth and can grow rapidly if there is a robust demand
- The competitiveness gains were more than cancelled by the appreciation of the euro against the US dollar and Asian currencies between 2001 and 2004. The euro area needs a weaker exchange rate in the light of the high level of unemployment
- From 1988 to 1999, some countries succeeded in depreciating their currency against the Deutsche Mark in real terms: Finland, Italy, Spain and, outside the future euro area: Sweden.
- Germany, Austria and Portugal joined the euro area at too high exchange rates which induced substantial current account deficits.

Competitiveness and current account balances

- Since 1999, Austria and Germany have succeeded in restoring their competitiveness.
- While Italy seems unable to maintain competitiveness without time-to-time devaluation, Italy and Portugal have been more hit than the average area by the emergence of China.
  - Fixed exchange rates and rigid inflation rates can induce persistent exchange rates misalignment periods. Countries can no more devalue their currency and wage moderation policies are the only tool left to restore competitiveness but take a long time to play and are painful, since they depress demand both at home and in the area.
  - These non-coordinated policies have widened current account imbalances: in 2005, Germany and Netherlands run huge external surpluses while Spain, Greece and Portugal run large deficits.
- National saving rates are very low in Greece, Spain and Portugal which is unusual for countries growing at a rapid rate
- Output growth is high in Greece, Spain, the UK, and the US, with very low national and households saving rates. On the contrary, Belgium, Germany, Austria and France suffer for too high saving rates. Low saving rates seem necessary to have high growth and low public debt. Virtue is dangerous in Europe, since a weak domestic demand induced by a high savings ratio cannot be offset by low interest rates or large public deficits.

External positions

	Competitiveness*		Current account balance, % of GDP		National savings rate	Households net savings ratio
	1998	**2005**	**1998**	**2005**	**2005**	**2005**
Euro area	**108**	**100**	**0.8**	**0.0**	**20.6**	**n.a.**
Belgium	104	96	5.2	2.5	23.7	6.2
Germany	101	109	-0.8	4.2	22.1	10.7
Greece	89	77	-3.0	-7.9	15.8	n.a.
Spain	108	95	-1.2	-7.4	16.9	5.4
France	101	100	2.6	-1.7	19.9	11.6
Ireland	92	107	0.8	-2.6	25.5	n.a.
Italy	114	95	-3.0	-1.1	20.5	9.5
Netherlands	105	96	3.2	6.6	24.0	5.7
Austria	95	114	-3.1	1.2	22.7	9.5
Portugal	97	73	-7.1	-9.3	15.7	4.9
Finland	127	122	5.6	5.2	19.0	n.a.
Denmark	*101*	*89*	*-0.9*	*2.9*	*23.8*	*-5.8*
Sweden	*110*	*132*	*3.9*	*6.0*	*22.9*	*n.a.*
UK	*92*	*86*	*-0.4*	*-2.2*	*15.4*	*0.0*
US	**94**	**108**	**-2.4**	**-6.4**	**14.5**	**-0.4**

*** 1988 = 100; on the basis of unit labour costs in the manufacturing sector. A rise means competitiveness gains.**
Source: OECD.

Too passive fiscal policies

- European Countries have adopted two kinds of fiscal strategies:
  - Some (Belgium, Spain, Ireland, the Netherlands) made the effort needed to bring their budgetary positions in balance, or even with a structural surplus (Finland), either to comply with European rules, or because of robust growth, or to prepare for future rises in old-age related spending.
  - Other countries have instead maintained a structural deficit, either because they could more easily resist European pressure due to their size (Germany, France, and Italy) or because they used creative accounting to minimise their deficits (Portugal, Greece).
- The SGP strategy: bringing structural government balances to 0 before allowing automatic stabilisers to play – without any discretionary policy allowed -, was not implemented in the larger economies, although they did not form a coalition to change the fiscal strategy either.

Too passive fiscal policies

- In the last recession (2000-2004), fiscal policies were hardly used to support GDP growth in the euro area:
  - Fiscal impulse was 1.2 percentage point of GDP only, as compared to 5.6 in the UK and 6 in the US.
  - Except for Greece and Finland, euro area countries implemented close to neutral fiscal policies.
- The SGP was a corset for fiscal policies in these low growth years.
- The objective of bringing debts to below 60% of GDP was not fulfilled: government debts still stand at around 100% of GDP while the French and German debts have risen at above 60% of GDP.

Fiscal Policy

Percentage of GDP	Government balance, 2007	Fiscal impulse* 2000/2004	Gross public debt, Maastricht definition, 2007	Net public debt
Euro area	**-0.6**	**1.2**	**67**	**45**
Belgium	0.2	0.6	85	73
Germany	0.0	1.1	65	45
Greece	-3.1	7.1	95	69
Spain	2.2	-0.4	36	21
France	-2.7	1.5	64	34
Ireland	0.3	2.8	26	1
Italy	-2.4	2.4	104	91
Netherlands	0.4	0.0	45	42
Austria	1.3	-2.7	59	35
Portugal	-2.7	1.3	64	43
Finland	5.3	4.9	35	-71
Denmark	*4.5*	*-0.4*	*26*	*-2*
Sweden	*3.4*	*3.1*	*41*	*-21*
UK	*-3.0*	*5.6*	*44*	*30*
US	**-3.7**	**6.0**	**63**	**44**

*** The Fiscal impulse is the change in the primary cyclically adjusted government balance. A positive figure reflects an expansionary policy. Source: OECD.**

Too passive fiscal policies

- However public finances are more sustainable in the euro area than in the US, UK, Japan.
- Public finances have deteriorated in the euro area because of a persistent negative output gap.

Public finances sustainability in 2006

Percentage point of GDP	Structural balance	Output gap	Limit for gov. balance*
US	*-3.7*	*0.6*	*-3.0/-3.3*
Japan	*-5.3*	*0.5*	*-1.0/-3.0*
Germany	-2.1	-1.7	-1.7/-2.7
France	-2.1	-1.7	-1.8/-2.8
Italy	-3.6	-1.3	-1.9/-4.3
Portugal	-2.8	-4.1	-2.3/-4.0
Greece	-3.5	1.2	-3.3/-7.0
UK	*-3.1*	*-0.8*	*-2.0/-2.5*

What EMU@10 report said?

- In May 2008, the Commission published a rapport on 10 years of EMU. The report mix important scientific works, advertising sentences and a contestable political and economical strategy.
- EMU brings macroeconomic stability but not growth.
- EMU avoids exchange rate realignment but not misalignment (in the zone or with the dollar).
- Budgetary discipline has increased but we do not have a good coordination between monetary and fiscal policies. SCP induced persistent conflicts between the Commission and the MS.
- Financial market integration increased but also financial instability (in 2001/02 as in 2007/08).
- The Commission promotes market liberalization but forgets fiscal and social harmonisation.
- Euro becomes the second international currency but euro level affects European industries competitiveness.

What EMU@10 report said?

- EMU has a strategy about globalisation: innovation and specialisation in high value-added sectors but is it enough for the losers of globalisation?
- Structural reforms remain national as do problems. It remains hard to have an European Agenda. Is it compatible with the democratic process?
- Divergences between countries remain. Big countries have specific problems. The only strategy for the Commission is flexibility. Is it enough?

What EMU@10 report proposes?

- The SGP, the SGP, the SGP, with more surveillance….
- The Commission evokes “the benefit of future generation”. But why the Commission refuses the “golden rule” as a medium objective?
- A good idea: to address macroeconomic imbalances (but why the Commission seems unable to forget the SGP?)
- More coordination in structural reforms. But this means only more flexibility. It is enough? Are MS condemns to the liberal models with inequalities and instabilities? What about “social Europe”? “Social cohesion”? Ecological strategies?
- Can we have more market integrations without fiscal and social harmonisation?
- Do European societies need more wage flexibility and wage differentiation? When the wage share has decreased and wage inequalities increased?
- It there any alternative? The Scandinavian model rather the liberal one?

What EMU@10 report proposes?

- Can we prone more financial integration without a strategy about financial instability?
- The Commission wants that Europe speak by only one voice in international economic affairs. But do MS agree? What will be the international strategy of EU? A liberal one (more flexibility) or a social-democrat (more international governance)?
- The problem of the compatibility between democracy and European organization remains.

Structural issues: the Lisbon Strategy

- In fact, the European Commission does not recommend a pure liberal solution, but a mixed strategy based on a *sound* macroeconomic policy, on increasing markets flexibility, a reform of social protection to decrease its weigh and to raise employment incentives but also a public support for innovation.
- The Lisbon strategy was a technocratic project, without mobilization of the European opinion, involvement of the civil society and of the social partners. The strategy is defined by a technocratic structure, without democratic debate, taking account of the differences between the countries, of the trade-off necessary between various objective, of the differences of opinion and interest of the social forces.
- In December 2007, the Commission settles a New Community Lisbon Programme (CLP), which is less ambitious.
- Macroeconomic issues are forgotten. Programmes do not deal with the question of financial system reform, with tax or social harmonisation.
- Will this programme have any impact on national decisions?

10 keys objectives

- A new Social Agenda focussing on education, migration and demographic evolutions. Not on poverty and social cohesion. To remove the barriers in the single labour market.
- A common policy on immigration. A blue-card to attract skilled-workers. What for the others?
- A Small Business Act.
- A reduction by 25% of administrative burdens.
- To strengthen the single market and to increase competition in services. Nothing about social harmonisation and workers rights?
- A “fifth freedom”, the free movement of knowledge
- To improve the framework for innovation, to improve its financing,
- To complete the internal market for energy (is it the good strategy?) and to adopt the climate change package.
- An industrial policy geared towards more sustainable production and consumption.
- New opportunities for international trade.

Institutional disparities

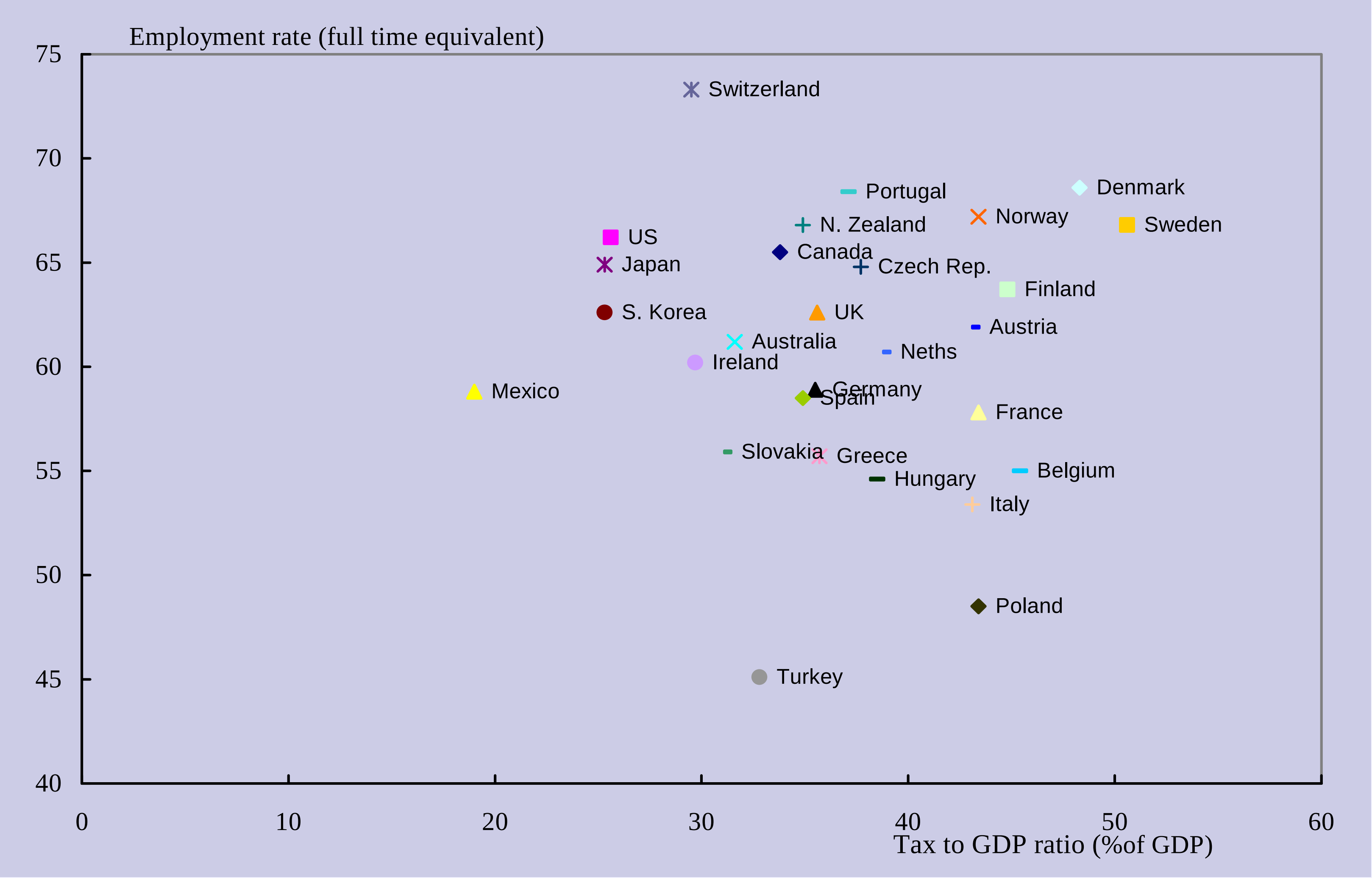
- Euro zone countries differ also in terms of institutional factors.
- Most countries, except Spain and Ireland, have high levels of public expenditure (> 50% of GDP).
- At the euro area level, the share of primary structural public spending was the same in 1990 and 2005.
- The share has risen in several countries: Portugal (by 11 percentage points), Belgium (4) and France (2.5) and outside the euro area, the UK (5 percentage points). The share has fallen in other countries: the Netherlands (6 percentage points), Spain (4), Ireland (2.5), and also in Sweden (6 points).
- The European Commission has failed to impulse public expenditures cuts in the European Union and countries have hardly converged. High levels of public expenditure require high levels of taxation.
- But, as the Scandinavian example shows, high tax to GDP ratios are consistent with high employment rates (see chart 1).

Public expenditure

In % of GDP	Structural Primary expenditure	
	1990	**2005**
Euro Area	44.3	44.1
Austria	48.4	45.5
Belgium	41.0	44.8
France	47.8	50.3
Finland	48.8	48.6
Germany	43.4	42.9
Greece	40.4	41.9
Ireland	36.1	33.7
Italy	43.0	42.9
Netherlands	48.2	41.9
Portugal	32.8	43.6
Spain	40.5	36.1
Denmark	48.4	50.5
Sweden	60.3	54.3
UK	38.5	43.5
Japan	29.8	35.6
US	31.2	31.9

Source: OECD.

Employment rates and taxation rates



Source: OECD.

Tax harmonisation

- Taxation is high in EU countries. Tax to GDP ratios stand at around 40% as compared with 25% in Japan and the US. This high level of taxation allows the funding of the European social model characterised with a high level of public expenditure and transfers. It is hence crucial for European countries to keep their capacities to collect tax revenues, according to democratically agreed rules.
- The European social model is threatened by globalisation that puts tax and social domestic systems into competition. Taxing the more mobile factors (big companies, financial capital, highly skilled workers and wealthy people) is more and more difficult, which undermines domestic redistribution policies. As unanimity is required, tax harmonisation progresses very slowly in Europe, which obliges MS to reduce the rate on firms and to reduce taxes on the wealthiest households.

Tax harmonisation

- The European treaties stress four ‘fundamental freedoms’: free movement of persons, services, goods and capital. However, the texts do not say anything on the need for countries to remain responsible for domestic taxation. Besides, the logic of European integration is such that the Commission wishes decisions to be taken at its level; it is thus not in favour and may even be against measures guaranteeing domestic taxation autonomy. Member states should therefore pay attention to keep their fiscal autonomy, although they rarely do.
- Only the taxation of interest income has been harmonized. All countries will eventually declare interest paid to community residents to their countries of origin, some countries may in a transitional period levy a tax.
- The taxation of resident households is not harmonized. Also, the rich tend to flee the countries which capital or inheritance, which oblige countries to gradually abandon theses taxes.

Tax harmonisation

- France loses a lot of time and energy to gain the right to extent the reduced VAT rate on restaurants, which is not useful from an economic point of view.
- France and UK propose a “green VAT” which is difficult to implement.
- Europe needs to introduce a important and coordinated ecological taxation. But the progress is rather slow, as countries have different interests. The taxation may be useful to reduce taxes on labour. In 2008, the ecological taxes remains small and non coordinated.
- The growing number of European companies make necessary to reach a harmonisation of business taxation. EU did not succeed to reach an agreement and many countries have embarked on tax competition by lowering the rate of corporation tax. Some countries wants a minimum rate is established, but the United Kingdom, Ireland and New members refused.
- The Commission suggests a harmonisation of tax bases, but without harmonisation of the tax rates, which is not acceptable.

Tax harmonisation

- Regarding enterprises, the principle of taxation at source should be reaffirmed, so that each company pays property taxes for the profits it has made in a given country. What is needed is the introduction of minimum rates, depending on the level of development reached by the country, for instance 20% for New Member States and 30% for the old Member States. The lower minimum rate will increase as countries converge.
- To preserve its social model, Europe should fight more vigorously against the possibilities of tax evasion induced by globalization. An important issue on a global scale is the need to fight against tax havens and offshore centres, which launder dirty money and promotes speculation and tax evasion. The major industrial countries should prohibit their firms and their financial institutions to make financial transactions, to have activities, to have subsidiaries in these countries. Neither France nor Europe has so far taken this fight seriously.

Four models?

- European countries can be classified in four models (Esping-Anderson, 1990):
  - **Scandinavian model:** very high level of social expenditure based on citizenship, funded through taxation, high female employment rate, low social inequalities and a strong cooperation between social partners (Finland, Netherlands and also Denmark and Sweden).
  - **Continental model:** high level of social expenditure, based mostly on activity, financed by social contributions, a high level of labour protection (Germany, France, Belgium, Austria).
  - **Mediterranean model:** intermediate level of social expenditure based on activity, financed by social contributions, low level of family and unemployment benefits offset by family solidarity, low female participation rates, and high level of labour protection (Italy, Greece, Spain, Portugal).
  - **Liberal model:** low level of social expenditure, based on citizenship, targeting the poorer, and with a low level of labour protection (Ireland and also the UK).
- Replacement ratios derived from unemployment benefits are high in most euro area countries, at the exception of Mediterranean ones (Spain, Greece, Italy), where unemployment rates are not particularly low. Employment protection is high in continental and Mediterranean countries, as compared to liberal and some Scandinavian countries.
- These discrepancies make difficult the convergence of social policies in EU.

Social protection indicators

	Social protection public expenditures, % of GDP	Net replacement rate, 2004	EPL, 2003
Belgium	30.1	66	2.5
Germany	30.2	75	2.5
Greece	23.8	33	2.9
Spain	22.1	52	3.1
France	33.4	71	2.9
Ireland	20.1	71	1.3
Italy	20.9	6	2.4
Netherlands	24.8	79	2.3
Austria	29.7	73	2.2
Portugal	27.8	72	3.5
Finland	29.4	75	2.1
Sweden	36.7	77	2.6
UK	26.3	66	1.1
Denmark	34.3	77	1.8
Japan	21.1	66	1.8
US	n.a.	29	0.7

Source: OECD.

Indicators of social performance

- **Life satisfaction** is the highest in Scandinavian countries (and in the Netherlands); it is the lowest in Mediterranean countries.
- **Income inequality:** Scandinavian countries show the more equal income distribution. Mediterranean and liberal countries the more unequal.
- **Poverty rates** are significantly higher in liberal and Mediterranean models; this reflects the unequal income distribution.
- **Life expectancy** is lower in the Anglo-American countries than in Scandinavia (except in Denmark), Continental Europe and the Mediterranean countries.
- **Infant mortality** - an indicator of the efficiency of the health system – is substantially higher in liberal countries. Denmark seems to have a specific problem.

Indicators of social performance

- **Hours worked:** It appears that high GDP per capita in liberal countries is largely due to a high number of hours worked. Labour productivity per hour is relatively high in continental countries.
- **Prisoners:** The share of prisoners is very high in the United States, and also relatively high in the United Kingdom. It is small in Scandinavian countries.
- **Trust in people** is more common in Scandinavian countries (and in the Netherlands) than in other countries. This shows that the Scandinavian model is based on social practices that are deeply rooted in peoples' minds and that it may be difficult to extend it to other countries where such practices are not a tradition (Algan and Cahuc, 2006)
- Globally, the social performance in the United States and in the liberal European countries is worse than in Scandinavian and Continental European countries.
- During the last years, poverty rate seems to increase in Nordic countries and to slightly decrease in France and Germany. But there are a lot of statistical issues.

Social indicators

	Life satisfaction		Inequality of income distribution	At-risk-of-poverty rate after soc. transfers	Life expectancy at birth	Infant rate mortality per 1,000 births
	2006	**1996-2006**	**2005**	**2005**	**2004**	**2004**
Continental Model	*2*	*+2*	*4.0*	*13*	*79.1*	*4.1*
Germany	17	-1	4.1	13	78.9	4.1
France	19	+7	4.0	13	79.6	3.9
Belgium	31	+6	4.1	15	79.1	4.3
Netherlands	44	-2	4.0	11	78.5	4.1
Austria	23	-6	3.8	12	79.2	4.5
Mediterranean Model	*16*	*+4*	*5.7*	*19*	*79.6*	*3.9*
Greece	11	+2	5.8	20	78.3	4.1
Italy	14	+2	5.6	19	80.2	4.1
Portugal	4	±0	8.2	20	77.5	4.0
Spain	22	+8	5.4	20	79.7	3.5
Scandinavian Model	*48*	*+7*	*3.6*	*11*	*79.2*	*3.5*
Denmark	66	±0	3.5	12	77.3	4.4
Finland	33	+6	3.6	12	78.7	3.3
Sweden	46	+11	3.3	9	80.3	3.1
Liberal Model	*34*	*+5*	*5.6*	*19*	*78.5*	*5.1*
Ireland	37	+3	5.0	20	77.9	4.9
United Kingdom	34	+5	5.6	19	78.5	5.1
EU 15	23	+3	4.7	16	79.2	4.1
United States	–	-	-	-	77.5	6.9

Social indicators

	Hours worked	Productivity by hours	Prisoners in population (per 100,000)	Trust in people
	2004	**2005**	**2005**	
Continental Model	*1,443*	*98.3*	*97*	*0.31*
Germany	1,443	94.1	97	0.33
France	1,441	101.5	88	0.21
Belgium	1,522	110.7	90	0.29
Netherlands	1,357	105.7	127	0.59
Austria	1,550	85.1	108	0.31
Mediterranean Model	*1,695*	*75.0*	*115*	*0.30*
Greece	1,925	70.8	90	0.20
Italy	1,585	77.4	97	0.32
Portugal	1,694	50.3	123	0.10
Spain	1,799	76.7	143	0.35
Scandinavian Model	*1,586*	*85.9*	*77*	*0.63*
Denmark	1,454	87.8	77	0.64
Finland	1,736	81.5	75	0.57
Sweden	1,585	87.3	78	0.64
Liberal Model	*1,667*	*86.7*	*139*	*0.29*
Ireland	1,642	104.1	85	0.35
United Kingdom	1,669	85.2	143	0.29
EU-15	1,565		109	0.32
United States	1,824	100	738	0.36

Sources: EIRO; OECD; UNDP; WIFO calculations.

Poverty rate

FONDATION NATIONALE DES SCIENCES POLITIQUES
OFCE
Observatoire Français des Conjonctures Économiques

	1995	2006
Austria	13	13
Belgium	16	15
Finland	8	**13**
France	15	13
Germany	15	13
Greece	22	21
Ireland	19	18
Italy	20	20
Netherlands	11	10
Portugal	23	18
Spain	19	20
Denmark	10	**12**
Sweden	8	**12**
UK	20	19
	2000	**2006**
Czech Republic	8	10
Estonia	18	18
Hungary	11	16
Latvia	16	23
Lithuania	17	20
Poland	16	19
Slovakia	n.a.	12
Slovenia	11	12
Bulgaria	14	14
Romania	17	19

How to adapt the ESM?
National reforms or a European pilot?

- **Convergence** or respect of national specificities?
- Three reasons for **convergence:**
  - To help the Market Integration. Social system discrepancies become difficult to deal with when economic integration increases.
  - To prevent the race to the bottom and the social dumping. However this risk has not materialised yet and the threat remains theoretical
  - To increases the European citizenship. The Commission tries to intervene in this domain to make visible the importance of European Institutions.
- But convergence is impossible of national models are too different, too depending of history and social institutions. European citizens are not ready for a European solidarity.
- National system cannot be reformed from EC without the intervention of social partners.

Five points of view of the future of EMS

- The “market-oriented view” expects that globalization and EMU will oblige continental countries to move towards the Anglo-Saxon model.
- The sovereignists (like the Scandinavian, UK and most NMS) want to keep all their autonomy in social protection system. For how long will domestic disparities remain consistent with the Internal Market, with the free movement of goods, capital and services? But not every national specificity must be respected.
- Very few people suggest a big bang leading to a unified system in Europe. This would raise insoluble issues: solidarity remains today at the national level and there is no EU solidarity. The only system that could be easily extended would be a liberal system. However, a move towards a single system, under the effects of increased labour mobility in Europe, the development of European companies, increased competition and possibly ECJ’s decisions cannot be totally excluded.

Five points of view

- The proponents of a Social Europe are in favour of a progressive convergence towards a unified social model in Europe, embedding a high level of social protection. The evolution towards a social and economic EU government would allow for the harmonisation of taxation and social protection to the top. Social minima (minimum incomes, replacement rates for unemployment and pensions benefits) and wage minima would be settled according to the level of domestic economic development and would increase in catching-up countries. Social Europe would allow for the coordination of wage increases and hence would have positive demand effects while minimising the unfavourable effects in terms of competitiveness.
- But Anglo-Saxon countries and NMS refuse to be seen imposing a model which appears today in crisis in the large countries continental, unable to avoid the high unemployment and the development of exclusion and which the financial prospects are not assured. The unification of strongly disparate systems appears problematic, as well on the technical level as on the political and social level. It supposes homogeneity of Europe much stronger than it is it really.

Five points of view

- In the current strategy, European authorities try to impulse progressive but converging reforms aiming at *modernising* national social protection systems.
- But modernisation is a dangerous objective. It means to increase the gain from work by decreasing the social benefit of unemployed, retired people, women or people with incapacities.
- Such a convergence would be obtained through soft methods, like the BEPGs or the Lisbon Agenda and like the open method of coordination, each country however keeps its autonomy in social areas. This process is necessarily slow and not visible for economic agents and populations. It remains disconnected from national debates and reforms. The BEPGs and the OMC are dialogue processes between European and national administrations and do not really involve national social players, as they are hardly debated at the country level and in the general public.
- How should the process be democratised and strengthened? Currently the process is not mobilising and does not lead to the emergence of a Social Europe project. Moreover, its content raises questions. In practice the role of European authorities stands between supporting a specific ESM and questioning it under the name of modernisation. But theses issues should be decided after a social debate by a democratic political process.

Enhancing Social Europe (February 7, 2007)

- A declaration for « Enhancing Social Europe » was released in February 2007 by 9 of the 27 Labour Ministers (Belgium, Bulgaria, Cyprus, France Greece, Hungary Italy, Luxembourg, Spain,). It is a minority text in Europe. In particular, no Scandinavian country signed. The declaration suggests "*to strengthen the ESM… by elaborating a vision for the future of Social Europe…by promoting with a balanced approach…to adaptations related to globalisation, while ensuring social rights and protection enshrined in the European tradition".* The four suggested directions are: employment policies and flexicurity (fighting against precarious work; developing minimal social standards); social cohesion (preserving the social goals and the universal and solidarity character of social protection systems; defining minimum incomes); equal opportunities (supporting rise in the female employment rate; strengthening family policies and network of nurseries); a better European social governance (evaluating the social impact of all Union policies; developing the European social dialogue).

Social Europe and the French presidency

- Social Europe is not at the centre of the French presidency objectives, even if its theme is "a more protective Europe".
- There is a report by Bernard Brunhes: "Un agenda social pour une Europe compétitive et solidaire". Some interesting ideas:
  - To work at the Commission level to solve the contradiction between the concurrence freedom and the rights of the workers (after the Laval, Viking and Rüffert decisions of the ECJ).
  - To protect the public and social services (Services of General Interest) from the Concurrence legislation
  - To adopt European objectives in terms of poverty rate and minimum wages.
  - A great declaration by the European Council; a European Social model exist and we all want to maintain this model, even if this model needs to evolve.
- ETUC ask the French Presidency to act for a strong Social Agenda (2010-2015).

Which policy answers?

Less Europe? The re-nationalisation of economic policies

- The strategy of the re-nationalisation would consist in giving again national governments room for manoeuvre to implement specific economic strategies. The organization of economic policy in Europe would be re-examined while seeking with better preserving the autonomy of the Members States. Those would be authorized to implement national industrial policies, to protect their tax revenues with measures fighting tax avoidance, to choose freely their social model, etc.
- However, euro zone MS would continue to share a common monetary policy, interest rate and exchange rate. It would always be necessary to define some code of good conduct which should lead to penalize excessive inflation rates or external deficits. The countries would thus not have the possibility of choosing their policy mix. It also appears difficult to re-nationalise the external trade policy.
- Any hope of taxation or social harmonization would disappear. Each country would have to define its specific strategy vis-à-vis globalisation. The risk would be great that this re-nationalisation reinforces the temptation of not-cooperative strategies, of social and tax dumping.
- The countries would have no choice but move towards the liberal model.

Which policy answers?

More Europe?

- Economic policy could not be decided at the area level. Europe is not a nation: there is no unification of the political and social lives. Taxation and social protection systems are not unified. Economic situations remain different. No consensus on economic policies, institutions, reforms, strategy exists among the area; divergence can only be decided by a democratic election. But European peoples would probably not agree with economic, political and social unification decided at the European level. It is difficult to imagine a single organization able to manage different national situations.
- Europe governance will need national policies coordination. The euro area seems more appropriate for such co-operation than the EU-27 because it includes more homogenous economies. But this supposes that countries agree to share a common “European economic and social model”, that will need to be defined, protected, and be able to evolve.

Which policy answers?

More Europe?

- However, the policy to be followed and the governance remain a delicate issue. **Economic policy should combine Keynes, Colbert and social democracy.**
- In a mass-unemployment situation, the euro zone needs a growth-oriented policy mix. It would be desirable to set up real economic policy coordination in the framework of the Eurogroup, with whom the ECB would have to dialogue. This co-ordination should not focus on public finance balances, but should aim at supporting economic activity and achieving a 3% annual growth target, as in the Lisbon strategy. The process will have to take into account countries disparities. The task is not so easy.

Which policy answers?

More Europe?

- Europe must try to design a specific model of European firms, caring about employment, growth in the area where they are located and by durable growth. Companies have a social role to play. They must take account of the interests of their employees and customers, not only of that their shareholders. This supposes that Member States maintain relatively high company taxation, and subsidize firms locating their activities in lagging areas and to help the economic sectors in difficulty, as to provide them incentives to innovation and research. States should have an active industrial policy, aiming both at developing Large European Companies and at supporting the development of innovating SME and Research Centres networks. European authorities should plan the future of productive activities and industrial employment in Europe; reduce the weight of competition policy and promote a European industrial policy within the framework of the Lisbon strategy.

Which policy answers?

More Europe?

- The objective would be to maintain the European social model, characterized by a significant level of transfers, public expenditure and thus of taxation. The system will have to be preserved from tax and social competition by harmonisation in Europe that will have to include the prohibition of unfair competition but also the introduction of minima rates for taxation (corporate taxation, tax on wealth and on higher incomes) and for benefit (minimum income, minimum pension replacement ratio) and by strong measures against tax havens at a worldwide scale.
- The European Social Model will have to rely on its comparative advantages (free education and health for all, public infrastructures, social security benefits) to remain competitive in spite of globalisation. With a more dynamic growth, the decrease of unemployment rate would allow to extent in Continental countries a “flex-security system” inspired by the Scandinavian model, which should included a more precise follow-up of the unemployed.

Which policy answers?

More Europe?

- A new economic policy in Europe will require difficult economic and social choices:
- A robust growth is needed in the short-term in order to reduce unemployment, but in the long run it would increase environmental imbalances. It will be necessary to re-orientate production and consumption, but this will have a cost in term of purchasing power which people will have to accept.
- Does Europe have to open the door widely to immigration to compensate for its demography or is it necessary to ensure first full employment and the rise in workers skills?
- Is it necessary to do everything to encourage employment of older workers, people with incapacity, and mothers with young children? Yes, of course, because a job develops capacities and integration in the society.
- But this policy implies lower incomes for the people of targeted categories who do not succeed in taking a job. Also, is any kind of job positive for the individual? Should not we use part of productivity gains to lower working time and decrease the importance of market jobs? Is any market activity socially useful?

Which policy answers?

More Europe?

- Improving the European economic framework is not a technical issue; it requires a major change in the economic policy thinking, a new alliance between social classes concerned about full employment and social cohesion, the willingness to depart from the financial markets and globalised firms point of view. This move would be easier to undertake at the European than at a National level, but it would require an agreement between people of each EMU Member State, which would be difficult to reach.